7. Policy Recommendations

In Gallatin County, both landowners and developers alike need financial incentives to participate in a program that redirects their development potential into the County's growth areas. Our research finds that there is sufficient demand to drive a TDR market; average developer willingness to pay for an additional lot across all receiving areas is $7,229, meaning the willingness to purchase a TDR (with the 4:1 bonus) would be $28,916. The mechanics of the market as proposed seem to do an effective job at balancing demand with supply – in theory.

However, despite this economic theory, we believe there is some reason for concern. In addition to setting up the TDR program, the County's pending proposal also creates 160-acre minimum lot sizes in rural areas. The combination of the lot-size restriction and the further deed restrictions through the use of TDRs may be difficult to accomplish through the program as proposed.

In an environment such as Gallatin County, with no preexisting comprehensive county-wide density limits except those created by state subdivision law, many rural landowners have the perception - whether rightly or wrongly - that they are entitled subdivisions with lots smaller than 160-acres --perhaps 5 acres, perhaps 10 or 20 acres. Some believe that they will not receive adequate compensation for their expectations, given that the County would initially impose a restriction to 160-acre lots and then offer them the ability to further restrict development potential for TDRs as the only way to recoup some of this perceived loss in property value.

Thus, landowners may not perceive the TDR program as an incentive and may oppose it. If landowners choose not to use the program, the County will not grow, since it is hinging most of its future growth on TDR sales. Or it will grow via 5-acre lot development in its supposed "growth areas."[1] Either way, the land supply will not be available to developers, and therefore developers may cross the line to Broadwater County, as some already have, where development is easier and less costly.

For these reasons, we find it necessary that the County "decouple" landowner willingness to sell TDRs from a permanent deed restriction of his/her property that would further limit development potential beyond the initially imposed 160-acre minimum lot size/density.

It is important to accept that it will be difficult to create a program where everybody wins. Complete equity is unrealistic. Therefore, it is important to identify and address as much as possible who will and will not benefit from a County-wide TDR program.

Those who stand to lose the most are landowners of properties just outside the growth areas who have the perception – whether rightly or wrongly – that they can get 10- or 20-acre lots, but under this proposal would only able to get 160-acre lots. For these landowners, the TDR market will

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[1] This is because the base density in the growth area is 1 unit per 5 acres.

probably not be able to compensate them for their speculation on increased land value – that is, the difference in value between eight 20-acre lots and a single 160-acre lot.

Those who will benefit the most are owners of low-valued land who have no plans to develop in the future. These property owners will be able to generate a revenue stream from their land that did not exist before.

Finding ways to minimize the impact upon those most negatively affected and spreading the benefits among as many participants as possible should be an important policy strategy.

7.1 Alternatives: Term TDRs & Value-Based Credits (TDCs)

Limiting minimum lot sizes to 160 acres in the rural areas is perceived as a defacto down-zoning. When perceived in this way, it is very difficult to make a successful TDR program work. If the County's fundamental goal is to put in place this density regulation, then we suggest the guiding principle of its TDR program should be simply: "to provide financial compensation to rural landowners for the 160 acre lot size/density requirement by redirecting development potential into growth areas, while in no way limit the County's ability for future growth."

A program driven by such a goal will only work if: (1) it is simple and easy to use, and (2) it adequately compensates rural land owners. The following discussion describes how this might be the case.

Two options should be considered to accomplish the goal of density regulation in the rural areas.

As a first option, the County could consider a "term" TDR. In this case the landowner would deed restrict his/her property beyond the minimum 160-acre lot size/density requirement, but only for a period of time, in exchange for TDRs. For example, Mesa County in Colorado has a program that places 40-year deed restrictions on properties that are allocated TDRs.

The term-TDR removes much of the risk that landowners associate with permanent deed restrictions since they are only forfeiting future development potential for a period of time.
A deed restriction that sunsets after a given period of time does create a situation where land is being preserved only for a set period of time, rather than permanently. Thus, the County may have to deal with the issue of preserving or developing these lands again some decades into the future.

However, the likelihood that the program will succeed in the short run will be greatly enhanced. A term approach will bring many more landowners into the market and lower the price at which they are willing to sell. Specifically, it will encourage landowners who are just outside the growth areas to participate, rather than only those from the lower-valued rural areas that are unlikely to develop in the first place. This approach will not create a significant barrier to development in the

County nor will it hinder future growth, and importantly, it will enable the restrictions to the 160-acre lot size/density requirement.

A second option would be to craft a variation on the value-based method of assigning TDRs. Under this concept, the County would eliminate the acreage-based method of assigning TDRs and instead use only the value-based method. To make this idea viable in the marketplace, the County should also eliminate the deed restriction requirement in the sending areas – permitting landowners to build 1 residence per 160 acres and selling the excess TDRs into the receiving areas. Because this system provides sending-area landowners with a commodity to sell, rather than a right to build, we would suggest calling this commodity a transferable density *credit,* or TDC, rather than a transferable development *righ*t.

Furthermore, to avoid flooding the market in the receiving area with credits, the transfer ratio in receiving areas should be changed from 4:1 to 2:1. That is, a credit sold by a sending-area landowner to a receiving-area developer would permit construction of 2 additional units in the receiving area.

The creation of this value-based credit commodity should remove any landowner concern over permanent (or temporary) loss of development potential beyond the 160-acre lot size/density restriction. Importantly too, TDCs would be sold at a lower price since landowners do not have to recoup the loss in value created from a deed restriction. The lower price will make development in the receiving areas easier – especially those areas where the lack of infrastructure severely limits the amount developers are willing to pay for TDRs.

Using this value-based allocation, owners of more valuable land are given more TDCs to sell. This would offer more equity in the program and create incentives for owners of properties closer to the growth areas to participate in the program

The transfer ratio should be changed in order to help calibrate sending-area supply and receiving-area demand. We previously estimated buildout in the receiving areas to be 99,184 additional lots. As it is proposed, the value-based method, with its $20,000 "divisor" and 1 TDR equaling 4 additional lots, would yield 192,000 extra lots (see Table 5.1). If this number is cut in half it would be very close to the 99,184 that represents buildout. An easy way to accomplish this is to make each TDC equal to 2 additional lots rather than the 4 currently proposed.

However, it is important to ensure the TDCs created retain their value in the market. Therefore, all the TDCs the County creates should not be available at the same time when only 1,000 are likely to be demanded from developers in any given year. If so many more TDCs are available than demanded, it will lower the price to a detrimental point. The County could remedy this by regulating the number of TDCs that it allows to come on the market per year – this could be 1,000, 2,000 or 5,000 TDCs, and done by lottery to determine which properties are able to sell their TDCs in the market.

7.2 Critical Components

Besides adjusting the program to decouple TDR/TDC allocations from a deed restriction, several other important components are needed to create a successful program in Gallatin County. These are: (1) address the need for infrastructure in the receiving areas, (2) maintain the TDR/TDC value through strict policy enforcement, (3) work with the cities in inter-jurisdictional transfers, and (4) establish a TDR/TDC bank to facilitate the market.

Successful TDR programs designate receiving sites in areas with existing sewer, water and road infrastructure. Many receiving areas in Gallatin County do not have such infrastructure and developers would have to incur the costs of providing their own sewer and water systems. This acts to significantly reduce the amount of funds they would have available for TDR/TDC purchases. If the County is serious about a program, it needs to make development in its receiving areas more attractive than elsewhere, and should invest in infrastructure enhancements in these areas – doing so will catalyze the TDR/TDC market and increase market activity.

But infrastructure cannot be the only "carrot" to receiving area developers. The County must ensure TDR/TDC purchases are the only route to higher density in its receiving areas. This will ensure the currency retains its value. Allowing alternative ways developers can build at higher density will render the market ineffective and result in inadequate compensation, and ultimately an unused program.

A third critical component for the County is to work with the cities of Bozeman, Belgrade, Manhattan, and Three Forks in its TDR efforts. Interlocal agreements will not work unless the cities see that their best interest to, in essence, "charge" developers for density inside their jurisdiction rather than providing it through a more typical upzoning process.

A fourth and final point the County should consider as it develops its TDR/TDC program is to establish a bank. Whether the program involves the transactions of "term" TDRs or transferable "density credits," having a central market place where buyers and sellers can easily find each other is critical to a well-functioning program. This is especially important when the County is looking to rely on the program as the *only* means to grow at higher density in much of the growth areas.

It is important to think of the bank as a market-making mechanism. This can involve something as easy as a clearinghouse to bring willing sellers and buyers together, to providing administrative assistance in transactions, to holding annual auctions where landowners and developers come together and bid on TDR/TDC prices.

In a more sophisticated role, the bank could be capitalized with money up-front to buy TDRs/TDCs, hold them through time, and sell them opportunistically to stimulate the market in times of little market activity. This would help to ensure the program's success during its initial stages when confidence has not yet fully developed.

Alternatively, the bank could sell acquired commodities opportunistically based on some amount of time-accrued appreciation. The up-front capitalization could come from public bond sources or private capital. The rate of return (ROI) for borrowed money would be dependant upon a particular investor's willingness to accept risk and his/her return expectations. But by and large, the bank would probably only provide bond-like returns of 4% - 6% on lent money, and thereby only be able to attract more philanthropically motivated investors.

The bank can exist either as a County-run entity or as an NGO, separate from local government, but made to follow the rules as set forth by the County. However the Bank is operated, the presence of a Gallatin County TDR/TDC bank will serve as an important psychological support for all stakeholders involved - landowners, developers, and government officials alike.